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Crisis Resolution: What the IMF is Doing

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1. Introduction

It is a particular honor for me to be representing the International Monetary Fund (IMF) at a conference marking our sixtieth anniversary. It is 60 years ago since the delegates of the Bretton Woods conference assembled in New Hampshire.

It is clear from reading the papers of the time, that the key actors fully understood the weight of responsibility that lay on their shoulders. They were, after all, setting out to create a new global economic order; one which would focus on growth, stability and prosperity, and which would leave the Depression of the 1930s and the upheavals of war far behind.

They knew what they were doing. But I wonder if they envisaged how successful their ideas would turn out to be; and how durable. The framework they created has certainly stood the test of time, and has successfully weathered the occasional storm.

The world has changed, of course, far more, and in different ways, than anybody could have forecast in that New England summer. Remember, Bretton Woods took place a full year before the war ended. But the framework put in place then has survived largely intact. And so has the IMF's mission – to provide the stable international financial system that is essential to foster the expansion of trade and to promote economic growth that in turn raises living standards and reduces poverty.

Our mission is unchanged, but not our methods. The constantly evolving global economy has meant that from its early days the IMF had to be an institution accustomed to change. Our very success in achieving international financial stability enabled the resumption of private capital flows. But those flows in turn presented new challenges.

So we have always had to be adaptable. But the decade since our 50th anniversary turned out to be particularly challenging for us. A series of capital account crises in the 1990s tested the robustness of the international financial system to its limits.

That forced some pretty radical re-thinking about the best ways to prevent and resolve financial crises, both within and outside the IMF. Crisis prevention and resolution is at the heart of our work, of course. It is certainly the most visible aspect of what we do.

I want today to outline some of the changes we have made in order both to strengthen our work on crisis prevention and to make the resolution of crises more effective and less disruptive. In doing so I want also to emphasize that our work in this area encompasses much broader issues than many of us previously realized.

2. Crisis Prevention

I mentioned the rash of capital account crises in the 1990s. These came thick and fast. After Mexico came the Asian crises of 1997–98 – perhaps the point at which we came closest to a systemic crisis. Then there was Russia in 1998, Brazil in 1999, Turkey in 2000 and Argentina in 2001. These were all painful experiences for the citizens of the countries involved, and for those of us concerned to prevent each crisis from spreading.

Those years were an important learning experience for the IMF: even by our standards, we had to adjust rapidly to what was happening and in framing our response. We were not alone, of course – academic economists, too, were rapidly reviewing the conventional wisdom.

But look for a moment at the international financial system since 2001. We have had a global economic downturn – that is just the time when one would expect some countries to encounter difficulties, especially those most vulnerable to external shocks. Yet we have seen much less financial turmoil than we might reasonably have expected. It is arguable that the reforms already introduced, in the IMF and in many of our member countries, are beginning to bear fruit.

The best way of resolving financial crises, of course, is to prevent them from happening in the first place. The IMF puts a great deal of effort into this. We aim where possible to be pro-active: to encourage and assist our member governments to implement policies that will reduce the risk of crises and make their economies more resilient.

It is virtually impossible to judge how successful we are in this work, except by the absence of crises – and that will reflect a wide range of factors, not just the IMF's work. And, from the opposite perspective, we might always be right: but if our members did not accept our advice, there could still be crises.

We also seek to avert trouble when we see it looming. Even here, it is hard to isolate the IMF's role, when seeking to measure our success rate.

Trying to measure success is important: not because we want to take the credit but because we need to know whether what we do is effective. It helps us to judge how we detect when a crisis is imminent; and how to respond both to warning signals, if we spot them in time, and to crises when they do occur.

3. Pro-active Prevention

Thus, the biggest changes in the way we operate have been in what I called our pro-active work. For many years, the IMF has conducted surveillance of all member countries' economic policies, under Article IV of the Articles of Agreement. For most countries, this surveillance takes place every year, for some at slightly less frequent intervals. Staff analyze and assess economic policies, and aim to identify sources of potential weakness. In recent years, this work has been greatly strengthened and remains a central element of crisis prevention work.

Since this is, in some ways, an historical conference, perhaps I might be permitted an aside on this question of surveillance. Before the new Article IV was introduced in the 1970s, the major industrial economies were secretive about their economic policies, and especially so about their exchange rate policies. The IMF's official history of that period by Margaret Garritsen de Vries notes that before 1976, "the Fund found it awkward even to ascertain the exchange rate policies of many members."[1] Such was the atmosphere of secrecy and mistrust that even casual discussions between the Managing Director and Executive Directors "did not go well" – something of an understatement, I suspect.

Yet contrast that with the current IMF practice of publishing the reports of all Article IV consultations on our public website, unless a member government specifically objects to that; and only a very small number do object. Indeed, public endorsement of sound policies by the IMF is valued by members.

In fact, this public aspect of our surveillance work is more than a cosmetic device intended to pacify those who criticize us for being secretive. Publishing details of Article IV consultations can act as an incentive for the pursuit of sound economic policies: no government, whether from a large or a small country, relishes public criticism of any aspect of its economic policy.

But it is not just the manner in which we carry out our surveillance work that has changed. We have also broadened our criteria for assessing economic policies, as a direct result of what we have learned from the past and in particular what we have learned about the origins of crises.

4. Lessons Learned

Cast your minds back to the days of fixed exchange rates. The original Bretton Woods system of pegged rates served us well for many years, but it was not without its share of periodic crises. But the distinguishing feature of these crises was that they were current account crises. These were often caused by macroeconomic policies that were inconsistent with a fixed exchange rate, or by a

[1] Margaret Garritsen de Vries. 1985. The International Monetary Fund 1972–1978: Cooperation on Trial. Volume 2. Narrative and Analysis. Washington: IMF. p. 837.

marked deterioration in terms of trade against a backdrop of a restrictive trade regime and few foreign exchange reserves. Exchange controls prevented sizeable capital flows.

Private sector capital flows had largely dried up in the interwar period and capital flows during this first postwar era were largely official in nature: until the 1970s, capital account transactions remained heavily restricted. That changed with the ending of fixed rates which itself coincided with the oil price shock of 1973–74. By January 1974, the price of the benchmark Arabian light crude was 350% higher than it had been twelve months earlier. The oil producing countries were awash with cash that needed a home. "Oil revenues recycling" was born.

The period between 1973 and 1985 was characterized first by aggressive private bank lending to developing country governments, financed by deposits received from oil exporters; and then, from 1982, with the consequences of that aggressive lending, the problems of oil-importing developing countries unable to repay the debts they had taken on.

It was during this period that developing countries became the IMF's biggest customers: though it is perhaps worth noting *en passant* that even in 1960, when the IMF had only 68 members, two-thirds were developing countries (then known as less industrialized countries).

But in the developing country debt crisis of the early 1980s, IMF programs did not differ that much from what had gone before, except that there were now debt rollovers coordinated with private creditors, mainly the banks. Coordination was made easier because a relatively small number of banks held most of the sovereign debt.

By the 1990s, private flows had grown so rapidly that sovereign debt to the private sector, mostly bonds, greatly exceeded that to the official sector. In contrast with the 1980s, bondholders are far more numerous, are more scattered, and are more likely to have divergent interests. The crises of the 1990s were capital rather than current account crises, and it is this that has influenced our crisis prevention work.

Capital account crises have several distinguishing features:

- they can occur very rapidly, and can require a much more immediate response than current account crises;
- they occur because holders of a country's debt lose confidence in its ability to service that debt – this means that, in principle, a crisis can occur even if the country's macroeconomic policies are sound, if it is believed they will not be sustained, but when there are real doubts about macroeconomic policy, these can translate into a full-blown crisis very rapidly; and
- fixed exchange rates – we now know – tend to compound the problem – doubts about the sustainability of the exchange rate peg can precipitate a

crisis at least in part because it raises doubts about the ability to service debt.

The only effective policy response in such circumstances must include restoration of investors' belief that a country will be able fully to meet its debt service obligations. That, though, is easier said than done.

As I said earlier, prevention is far better – and easier – than cure. We now place much greater emphasis on the overall sustainability of government economic policies, when assessing a country's vulnerability. That judgment has, importantly, to include debt sustainability.

As I just implied, the IMF, in common with much academic opinion, has become markedly more skeptical about fixed exchange rates. It became clear during the 1990s that, with open capital accounts, countries can be extremely vulnerable to capital account crises if there is any doubt about the sustainability of the peg that, in turn, relates to the sustainability of debt servicing. Thus, with a fixed exchange rate there are two major sources of vulnerability: anticipation of exchange rate sustainability, or lack of it; and vulnerabilities arising because of balance-sheet mismatches between foreign-currency denominated liabilities and assets. Today, far fewer countries, especially among emerging market economies, are attempting to maintain fixed exchange rate regimes.

Sustainable economic policies must provide a stable macroeconomic framework. This is a prerequisite for the rapid growth that brings rising living standards and falling poverty rates. Macroeconomic stability is only achievable if there is firm control of the public finances, of course. But we also broadened the definition of what macroeconomic stability includes. Sustainable policies need efficient tax collection, and a well-functioning financial sector. But an effective judiciary, respect for property rights, contract enforcement and good governance are also important in creating a stable economic environment.

We now closely monitor the international capital markets as part of our surveillance work.

Our surveillance work aims to encourage the adoption of sound policies. But we also provide technical assistance to governments that have good intentions but lack the expertise necessary to put such policies firmly in place. This has grown increasingly important as we focus more and more on the quality and sustainability of fiscal and governance measures.

Of course, we also provide short-term balance of payments support in order to help meet financing gaps and so provide time for necessary policy adjustments. And when necessary we can provide financial support on a precautionary basis. Besides the conventional short-term assistance, we provide help on concessional terms for low income countries.

The support we provided Brazil in 2002 is a good example of the IMF's role in crisis prevention when one appears imminent and when underlying policies appear

sound. In the middle of that year, Brazil was gearing up for its Presidential election in November. Its macro policies were sound.

But investors apparently doubted that these policies would be sustained by the successor government. The IMF support announced at the time of investor uncertainty during the pre-election period committed the new government to maintenance of the fiscal and monetary framework and thus reassured the financial markets. All three major presidential candidates committed themselves to maintaining sound policies, should they be elected.

Even before the election, after the IMF support was announced the spreads on Brazilian bonds had started to fall. So far, the Brazilian government has maintained its commitment to sound and sustainable policies and has stated its intention to continue doing so. Spreads fell further after the election and the central bank was able gradually to make significant reductions in interest rates. Economic growth has recently picked up and this should help the government remain committed to sound policies.

5. Crisis Resolution

The changes I have described in our approach to crisis prevention are substantial. We have greatly strengthened our surveillance work and made it more rigorous, including a greater emphasis on debt sustainability, financial sector health, and sound institutions and governance. And we have stepped up the provision of technical assistance, to help governments implement sound and sustainable policies. As a result of these changes we believe that the defenses against crises are much stronger than they were during the l990s. But I do not need to tell you that we live in a rapidly-changing world. Sustainable policies are those that bring the prospect of future stability and prosperity – and not those which appeared to hold such promise even in the recent past.

And there will always be crises. It is simply too expensive to have a failsafe system, to prevent every crisis. But though we can be sure there will be crises in the future, we can never be certain from which direction trouble will come.

We do try to spot potential sources of difficulty by making vulnerability assessments. Given what we now know about the causes of capital account crises, we try hard to assess where the main sources of weakness are. It's not foolproof, though.

Even if it were, of course, we would still have to confront the fact that governments do not always heed warnings – from us, or from the financial markets. They may find it politically difficult to adopt the measures that would reduce their vulnerability to shocks; or they may simply choose to postpone the necessary measures and so run the risk that they will leave it too late to prevent trouble. In cases where the IMF is not providing financial support, we ultimately have little influence beyond persuasion.

I outlined earlier what we had learned about the source and nature of crises from our experience in the 1990s. But it is important to remember that each crisis is unique. There may be similarities, but each situation will be different. Trouble might strike because of inadequate macroeconomic policies; or because of weaknesses in the domestic banking system; or because of an unsustainable debt burden. Few crises involve default, though, even if some kind of debt restructuring is needed. Ultimately each situation requires a different response.

6. Sovereign Debt Restructuring

Particular problems arise, of course, when a crisis is caused, or accompanied, by an unsustainable sovereign debt burden. There has been much debate in recent years about how the resolution of such crises could be improved and made more orderly. One of the difficulties in recent cases has been the challenge of coordinating the response of the private sector creditors when there are many more of them. There is always an incentive for one or more creditors to hold out in the hope of getting better terms than the rest.

This problem is not new, of course – a vigorous debate was under way as far back as the nineteenth century. But the rapid growth of private international capital flows in the 1990s lent new impetus to the search for a solution.

As you know, there has been much discussion of these issues in recent years, and several ideas have been floated, including that put forward by the IMF in 2001 for a Sovereign Debt Restructuring Mechanism (SDRM) and several proposals for the greater use of Collective Action Clauses (CACs) in sovereign bond issues. Essentially, these make it easier for debtors to negotiate with a large number of creditors by binding all creditors to the outcome of negotiations if a large enough proportion of creditors accept them.

In 2003, the International Monetary and Financial Committee (IMFC) strongly endorsed the use of CACs, calling for this to become the standard market practice. And this is what has happened. It soon became clear that the inclusion of CACs in bond issues carried no financial penalty, and they have become commonplace, much sooner than many people anticipated. It is, however, much too soon to evaluate the contribution such clauses can make to improving the orderly resolution of debt crises.

The IMFC also endorsed the idea of a voluntary code of conduct for debtors and creditors. The IMF is contributing to the work under way on this.

7. Looking to the Future

As I have outlined, the IMF has made considerable progress in work both to prevent crises and to deal with them when they do occur. I think we have shown both our willingness and our ability to learn from experience. We have done so in

ways which some of our critics doubted. At the time, the Asian crisis was perceived in some quarters to have highlighted our shortcomings. Yet as I noted, a systemic crisis was avoided, and the Asian economies that had been affected recovered far more rapidly than anyone dared hope at the time the crisis struck. Indonesia was the last of the Asian crisis economies to complete its IMF-supported program; and it did so at the end of last year.

Complacency is dangerous, though, both for the IMF and for individual national governments. The absence of major crises at a time when one or more might have been expected does not mean we at the IMF can relax, any more than the global upturn means that governments can put off necessary economic reforms. Indeed, for governments, now is the ideal time to confront the economic problems they face, in order to make their economies more resilient to shocks. And for the IMF, any breathing space must be used wisely, to strengthen our crisis prevention work further.

There is always room for improvement, and indeed, we are likely to have a heavy agenda of reform in the next year or two. Our new Managing Director, Rodrigo de Rato, mentioned some of the issues on the table when he addressed a similar anniversary conference in Madrid this year. He noted, for instance, that the design of precautionary arrangements and contingent access to IMF credit are still on the agenda. The world economy is constantly evolving, and the IMF must continue to adapt to change and, where possible, try to stay ahead of the curve.

8. Conclusion

I started by commenting on how much has changed since 1944, and at the same time how little. The world is a very different place; and so is the IMF. Yet the principles agreed on at Bretton Woods have endured. A multilateral framework that fosters economic growth through the expansion of trade, underpinned by a stable financial system: that was what delivered the postwar surge in growth that brought so much benefit to so many people – and at a faster pace than ever before in history. And that is the framework that we still have, and those are the principles we in the IMF still seek to abide by.

And even though much has happened since even our 50th anniversary, I am struck by how much of what the then Managing Director, Michel Camdessus, said then still holds true. Let me quote:

> *"Few here would disagree that high-quality growth requires five ingredients: sound macroeconomic policies; structural policies that promote the efficient use of resources and a responsive supply side; an open trade and exchange regime; active and effective social policies; and good governance."*

But I think that the last word should go to one of the key figures at Bretton Woods. The then U.S. Treasury Secretary, Henry Morgenthau, was appointed Permanent President of the Conference. His words at the inaugural session powerfully remind us of the overarching aim of the founders – the aim that we all still share – and of why what we at the IMF try to so is of such great importance:

> *"Prosperity has no fixed limits. It is not a finite substance to be diminished by division. On the contrary, the more of it that other nations enjoy, the more each nation will have for itself....[And] prosperity, like peace is indivisible...Poverty, wherever it exists is menacing to us all and undermines the well-being of all of us."*

Our task is difficult – but it is surely worthwhile.